



Guideline

Subject: Prudent Person Approach

No: B-1

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By law¹, the board of directors of a financial institution is required to establish, and the financial institution is required to adhere to, "investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return." In addition, each financial institution must comply with the statutory investment limits set out in the applicable legislation (see Appendix).

This guideline outlines factors that the Office of the Superintendent of Financial Institutions expects the management and the board of directors of a financial institution to consider in establishing investment and lending policies and in ensuring that they are effectively implemented. It is meant to serve as a guide and the provisions of the guideline should be adapted by each institution to reflect the activities and risks of its business.

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¹ The legislative references are: section 465 of the *Bank Act*, section 450 of the *Trust and Loan Companies Act*, section 387 of the *Cooperative Credit Associations Act* and sections 492 and 551 and subsection 615(1) of the *Insurance Companies Act*.

Policy

Every financial institution is required to have written investment and lending policies. These policies should describe the objectives for the investment and lending programs and the overall risk philosophy of the institution. They should take into account the strength of the institution's capital and its ability to absorb potential losses.

The policies should take note of the liability structure of the financial institution and the anticipated demands for funds and address how maturity profiles are to be established on the portfolios of investments and loans in light of these demands. They should establish limits on the institution's exposure to a person or a group of associated persons and to interest rate and currency risk. In setting these limits the institution should consider its exposure under a variety of potential scenarios.

Procedures

Financial institutions are required to have written internal procedures outlining how the investment and lending policies will be implemented and monitored. Institutions should ensure that the policies are implemented by persons, either on staff or under contract, who have the appropriate level of expertise. These procedures should address exposures arising from both on-balance sheet and off-balance sheet items.

The procedures should:

- identify responsibilities and accountabilities;
- set out the process for recommending, approving, and implementing decisions; and
- prescribe the frequency and format of reporting.

In addition, they should describe the method for classifying loans and investments and the basis for valuing loans and investments that are not regularly traded. There should be written procedures describing custodial arrangements of these assets. In developing these procedure, reference should be made to the regulations on protection of assets.

Procedures should be in place to monitor and control the institution's exposure to fluctuations in interest rates, foreign exchange rates, and market prices.

Potential sources of conflict of interest should be identified and procedures should be in place to ensure that those involved with the implementation of the investment and lending policies understand where these situations could arise and how they should be addressed.

Limits

The investment policy should identify acceptable ranges for investments in different types of instruments, including cash, equities, bonds and debentures, and real property. The lending policy should establish limits on aggregate outstanding loans by type of loan broken down by major category (e.g., commercial, consumer). These broad categories should be further subdivided as necessary; for example, mortgages could be subdivided between insured and uninsured mortgages and limits set accordingly.

The policy should set limits according to the source of loans where third parties such as mortgage brokers or syndications are relied upon. In addition, there should be an aggregate limit established on externally sourced loans.

Financial institutions should set limits on investments and loans according to their quality. For example, financial institutions may use ratings from recognized rating agencies in establishing quality criteria for their investments. Internal criteria would have to be established for non-rated investments. Similarly, internal criteria should be established for assessing the credit quality of borrowers.

Where applicable, limits should be established on exposures to industries and geographic regions.

Financial institutions should establish limits to contain the risks arising from potential changes in currency or interest rates. They should have policies outlining the circumstances in which derivative instruments can be used. In addition, they should establish limits on the use of derivative instruments by type of instrument (e.g., swaps, options, futures) and by counterparty.

Approval

At least annually, the board of directors of the financial institution or a subcommittee appointed by the board should review and approve the investment and lending policies and be advised in writing of adherence to these policies. Deviations should be reported immediately. The board or subcommittee may delegate the responsibility for the day to day implementation and monitoring to management; however, ultimate responsibility rests with the board.

Providing Information to the Office

Institutions are not required to file policies and procedures with the Office on a regular basis; however, the written policies and procedures should be available for review immediately upon request.

The institution will be expected to maintain information on its portfolios presented in a manner that facilitates analysis, for example:

- a comparison of outstanding amounts against the limits established in its policies;
- an analysis of asset quality and concentration;
- an analysis of its interest rate and maturity mismatch, including the results of scenario testing as appropriate; and
- an analysis of the diversification of its funding sources.

Where information required to perform this analysis is not available through the filing of statutory returns, the Office may request supplemental information that expands on the areas of greatest risk.

**STATUTORY INVESTMENT AND LENDING LIMITS FOR
FEDERALLY REGULATED FINANCIAL INSTITUTIONS**

Type of Institutions	Restrictions on Commercial and Consumer Lending	Restrictions on Investments in Real Estate	Restrictions on Investments in Equities	Restrictions on Aggregate Investments in Real Estate and Equities
Life Insurance (Domestic)	Sections 503 and 504 - 5% of total assets if regulatory capital ≤ \$25 million - Superintendent approval if regulatory capital > \$25 million - No restriction on consumer lending	Paragraph 506(c) Aggregate of: -70% of regulatory capital -15% of non-par liabilities -25% of par liabilities -5% of liabilities in respect of prescribed annuities	Paragraph 508(e) Aggregate of: -70% of Regulatory Capital -15% of non-par liabilities -25% of par liabilities -5% of liabilities in respect of prescribed annuities	Paragraph 509(e) Aggregate of: -100% of regulatory capital -20% of non-par liabilities -40% of par liabilities -5% of liabilities in respect of prescribed annuities
Life Insurance and Fraternal Benefit Society (Foreign) (Note: Foreign Fraternal deemed to be Foreign Life)	Subsection 616(1) - 5% of assets in Canada where excess is ≤ \$25 million, per Investment (Foreign Co's) Regs. - No restriction on consumer lending	Subsection 618(1) -15% of assets in Canada	Subsection 619(1) -25% of assets in Canada	Paragraph 620(a) -No regulations promulgated
Fraternal Benefit Society (Domestic)	Section 562 - Aggregate of commercial and consumer lending set at 5% of total assets where capital is ≤ \$25 million per Investment (Canadian Societies) Regs.	Section 563 -15% of total assets -Per Investments (Canadian Societies) Regs.	Section 565 -25% of total assets -Per Investments (Canadian Societies) Regs.	Section 566 -No regulations promulgated
Property and Casualty Insurance (Domestic)	Section 505 - 5% of total assets, per Investment (Canadian Co's) Regs.	Paragraph 506(d) -10% of total assets	Paragraph 508(f) -25% of total assets plus more if excess assets maintained	Paragraphs 509(f) & (g) -30% of total assets, or up to 35% of total assets if assets that exceed the assets required under section 516 are maintained
Property and Casualty Insurance (Foreign)	Section 617 - 5% of assets in Canada, per Investment (Foreign Co's) Regs.	Subsection 618(3) -10% of assets in Canada	Subsection 619(3) -25% of assets in Canada	Paragraph 620(c) -No regulations promulgated
Banks	None	Section 476 -70% of regulatory capital	Section 478 -70% of regulatory capital	Section 479 -100% of regulatory capital
Trust and Loan Companies	Sections 461, 462 & 463 - 5% of assets if regulatory capital ≤ \$25 million - Superintendent approval if regulatory capital > \$25 million - No restriction on consumer lending	Section 464 -70% of regulatory capital	Section 466 - 70% of regulatory capital	Section 467 -100% of regulatory capital
Cooperative Credit Associations	Sections 398, 399 & 400 - 5% of assets if regulatory capital ≤ \$25 million - Superintendent approval if regulatory capital > \$25 million - No restriction on consumer lending	Section 401 -35% of regulatory capital	Section 403 -35% of regulatory capital	None

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